CHAPTER 14

SPECIAL EXPENSING AND AMORTIZATION RULES

This Chapter discusses Treasury Department proposals that, in conjunction with the proposed Real Cost Recovery System, provide the recovery of capital investment on a basis that reflect economic depreciation. Thus, the special rules allowing rapid amortization for various types of capital investment would be repealed. As a simplification measure, the provision allowing $5,000 of certain capital investments to be expensed annually would be retained. The scheduled increases in the limit would be eliminated.

RETAIN $5,000 LIMIT ON EXPENSING DEPRECIABLE BUSINESS PROPERTY

General Explanation

Chapter 14.01

Current Law

Under current law, taxpayers may elect to expense the cost of a limited amount of qualifying property rather than to recover such cost over time through deductions for depreciation. In general, property qualifying for this expensing election must be purchased for use in a trade or business and must otherwise be eligible for the investment tax credit. No investment credit is allowable with respect to amounts expensed under this rule.

For taxable years beginning before 1988, the dollar limitation on the amount that may be expensed is $5,000 per year. This limitation is scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for taxable years beginning after 1989. In each case, the limitation that applies to a married individual who files a separate return is one-half of the dollar limitation described above.

Reasons for Change

Expensing the cost of an asset that produces income for more than one year overstates the taxpayer's cost of producing income for the year. The overstatement of current deductions shelters other income from tax and thus results in a deferral of tax liability. This deferral advantage creates some incentive for investment in assets eligible for expensing, but only for taxpayers who would not otherwise have acquired qualifying property up to the amount eligible for expensing. For other taxpayers, the limited expensing election creates no marginal investment incentive.

In addition, permitting taxpayers to expense the cost of an asset creates compliance problems. After the year in which the asset is expensed, the asset is removed from the tax form. As a result, it is relatively easy to convert the asset to personal use or to sell the asset without complying with the rules requiring recapture of the deduction.

A limited expensing election does, however, have certain simplification advantages. For smaller businesses, expensing eliminates or reduces the recordkeeping and computational burdens of recovering an asset's cost over a number of years.

Proposal

The scheduled increase of the dollar limitation on expensing of depreciable business property would be eliminated, leaving the dollar limitation at $5,000.

Analysis

The proposal would not change the current treatment of any taxpayer. Elimination of the increase in the limitation should have little effect on investment in depreciable assets. The proposal would simply retain a *de minimis* alternative to the more complicated depreciation rules.

REPEAL RAPID AMORTIZATION RULES

General Explanation

Chapter 14.02

Introduction

Current law contains a number of special amortization and expensing rules that allow taxpayers to elect premature deductions for capital expenditures. The deferral of income tax that these provisions permit is intended to create incentives or subsidies for investment in certain assets or activities.

Some of these provisions originally were intended to be effective only for brief periods, but were later extended. Others have expired in whole or in part since they do not apply to expenditures made in the current year or in future years. Although these provisions target various industries and various assets, they have similar effects on the efficiency and fairness of the tax system and present related questions of tax and economic policy.

Current Law

1. **Five-year amortization of trademark and trade name expenditures.** Current law permits taxpayers to amortize over a period of at least 60 months any expenditure paid or incurred in the taxable year for the acquisition, protection, expansion, registration, or defense of a trademark or trade name, other than an expenditure which is part of the consideration for an existing trademark or trade name. (Section 177.) A separate election may be made by the taxpayer with respect to each separate trademark or trade name expenditure.

2. **Five-year amortization of pollution control facilities.** Current law permits taxpayers to amortize the cost of a certified pollution control facility over a 60-month period. (Section 169.) To the extent, however, that a pollution control facility has a useful life in excess of 15 years, or, in the case of recovery property, has a recovery period in excess of 15 years, a portion of the facility's cost is not eligible for 60-month amortization, but must be recovered through depreciation or through the Accelerated Cost Recovery System (ACRS).

A certified pollution control facility is a treatment facility used in connection with a plant or other property to abate or control water or air pollution, if (1) the plant or other property was in operation before January 1, 1976, (2) the facility is certified by the appropriate State and Federal authorities as meeting certain pollution control standards, and (3) the facility does not significantly increase the output, extend the life, or reduce the operating costs of the plant or other property. In general, a profitable or "break even" facility is not eligible for certification.

If an election is not made with respect to a certified pollution control facility, its cost may be recovered through depreciation or, in the case of recovery property, through ACRS.

3. **Five-year amortization of certain expenditures for qualified child care facilities.** Current law permitted employers to amortize over a 60-month period capital costs incurred before January 1, 1982, to acquire, construct, or rehabilitate child care facilities for their employees. (Section 188.)

4. **Five-year amortization of expenditures to rehabilitate low-income housing.** Current law permits taxpayers to amortize over a 60-month period expenditures to rehabilitate low-income rental housing (other than hotels or other similar facilities primarily serving transients). (Section 167(k).) Expenditures qualify for 60-month amortization only if they are incurred for additions or improvements to property with a useful life of at least five years. Expenditures for a taxable year with respect to a dwelling unit are eligible for 60-month amortization only if the aggregate of such expenditures over two consecutive taxable years including the taxable year exceeds $3,000. In general, a taxpayer's rehabilitation expenditures with respect to a dwelling unit are not eligible for five-year amortization to the extent that the aggregate of such expenditures exceeds $20,000. In certain cases, this limitation is increased to $40,000.

The election to amortize expenditures to rehabilitate low-income housing will not be available for expenditures incurred afer December 31, 1986 (except in cases where rehabilitation began, or a binding contract for such expenditures was entered into, before January 1, 1987).

5. **Five-year amortization of certain railroad rolling stock.** At the election of the taxpayer, current law permitted taxpayers to amortize over a 60-month period the adjusted basis of railroad rolling stock placed in service after 1968 and before 1976. (Section 184.)

6. **Fifty-year amortization of qualified railroad grading and tunnel bores.** Current law permits domestic railroad common carriers to amortize the cost of qualified railroad grading and tunnel bores over a 50-year period. (Section 185.) "Qualified railroad grading and tunnel bores" include all land improvements (including tunneling) necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.

Amortizable basis is not reduced upon the retirement of qualified railroad grading or tunnel bores, but no additional deduction is allowed on account of such retirement.

7. **Expensing of soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and field clearing expenditures.** Current law permits taxpayers engaged in the business of farming ("farmers") to deduct a variety of costs that would otherwise be capitalized or inventoried.

a. Farmers may deduct currently soil and water conservation expenditures that do not increase the basis of depreciable assets. (Section 175.) The deduction is limited annually to 25 percent of the taxpayer's gross income from farming. Deductible expenditures include costs of the following: leveling, grading, and terracing; contour furrowing; the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds; the eradication of brush; and the planting of windbreaks. Expenditures with respect to land held by the taxpayer for less than ten years are subject to recapture as ordinary income.

b. Farmers may deduct currently expenditures for fertilizer or other material used to enrich, neutralize, or condition farmland. (Section 180.)

c. Farmers may deduct currently expenditures incurred to clear land and make the land suitable for farming. (Section 182.) The deduction is limited in any taxable year to the lesser of $5,000 or 25 percent of the farmer's taxable income from farming. Expenditures with respect to land held by the taxpayer for less than ten years are subject to recapture as ordinary income.

8. **Seven-year amortization of reforestation expenditures.** Current law permits taxpayers to amortize over an 84-month period up to $10,000 of reforestation expenditures incurred in each taxable year. (Section 194.) Reforestation expenditures include amounts spent on site preparation, seed or seedlings, labor, and tools. Amortized expenditures are subject to recapture if the underlying property is disposed of within ten years from the year of the expenditure.

Reasons For Change

Summary

Government subsidies for particular industries and assets distort market-based resource allocations and the consumer preferences on which they are based. In circumstances where private markets fail to reflect the social value of particular goods or services, government intervention in the form of a subsidy may be appropriate. However, many recently enacted tax incentives for business do not address problems of market failure, but instead subsidize specific business activities at some cost in economic efficiency.

Even where government support of a particular activity is warranted, providing such support through the allowance of premature cost recovery deductions results in a subsidy that is difficult to measure or control, discriminatory in its effects, and poorly targeted to encourage the particular form of investment.

The value to a taxpayer of premature cost recovery deductions depends on a variety of factors unrelated to the purpose of the subsidy. For example, the benefit from premature deductions will depend upon the difference in the taxpayer's marginal tax rate for the years in which the premature deductions are taken and the marginal rates for the years in which deductions would have been allowed under general tax accounting principles. Similarly, interest rates and the level of inflation over the same period will affect the actual value of the premature deductions.

In addition, since the benefit from premature cost recovery deductions is greater for taxpayers with high current marginal tax rates, incentives in that form discriminate against new businesses which have not started to generate taxable income, as well as growing businesses which reinvest their profits in ways that reduce current taxable income. Thus, such businesses are encouraged to diversify through expansion or merger solely to increase their taxable income.

A subsidy in the form of premature cost deductions is also difficult to target. Ideally, the incentive should benefit the most efficient owners of the asset to which the subsidy is directed. Since the subsidy's value is dependent on marginal tax rates, however, there is a strong incentive for subsidized assets to be owned by taxpayers in the highest brackets, who may or may not be efficient owners.

Finally, a subsidy in the form of premature cost recovery deductions is difficult to monitor or control. The contingencies in the value of the subsidy make prediction of its revenue cost extremely difficult. Problems in targeting the subsidy make it difficult to measure the subsidy's effect, which may in turn result in the subsidy being retained beyond the point at which it provides an efficient incentive.

1. <u>Trademark and trade name expenditures</u>. A trademark or trade name distinguishes a firm and/or its products from other firms and/or their products. The costs of acquiring trademarks are capital outlays for an intangible asset, similar to expenditures to organize a business. Investors are willing to make such expenditures because in doing so they acquire an asset that will, over the course of time, yield a rate of return at least as high as could be earned by other investments. Although a trademark or trade name may prove to be unprofitable, or even worthless, there can be no presumption that it will decline in value. To the contrary, the ordinary investor acquiring a trademark or trade name expects the value of the asset to appreciate along with the development of the products that it represents. There is consequently no basis for imputing deductions for "capital cost recovery" for such investments.

There is no evidence that investment in a trademark or trade name yields a greater benefit to society than is reflected in the expected market return to the investor. Allocation of resources to such investment should thus be determined by general market principles. There is correspondingly no basis for a tax incentive through premature recovery of the costs of such investment.

2. **Certified pollution control facilities.** The special amortization rules for pollution control facilities were enacted in 1969, shortly after the enactment of Federal legislation which imposed phased-in restrictions on industrial plant emissions. The thrust of the environmental protection laws was to require producers and their customers to pay the costs of avoiding environmental damage in excess of the standards imposed. At the same time, concern was expressed that existing plants would be subject to burdensome retrofitting costs, which would place them at a competitive disadvantage compared to newer plants that were designed after pollution control requirements were imposed. The special amortization rules were adopted to mitigate the cost of retrofitting older facilities. Consistent with the transitional objective, the special rules were scheduled to expire after seven years (December 31, 1975), a period presumably long enough to bring pre-1969 plants into compliance with emission standards.

The special amortization rules for pollution control facilities are poorly designed to offset the burden, if any, that revised environmental standards imposed on operators of existing plants. Ordinarily, plants in industries where emissions are a major concern are continuously "replaced" and their capacity altered in an orderly process of maintenance, repair, and modernization stages. Thus, at the margin, revised emission standards raised investment and operating costs for "old" and "new" plants alike. The only cost disadvantage to "old" plants was the difference between (a) the total additional cost of incorporating emission control features into "modernization" programs, and (b) the total additional cost of incorporating emission control features into the construction of new plants. This difference, which reflected differences in operating costs as well as capital costs, presumably varied from industry to industry, and from plant to plant. Thus, the extra burden imposed on taxpayers operating old plants, if any, was not related in some simple way to the cost of a depreciable retrofit facility, nor was it approximately equal to the interest savings on deferred taxes provided by five-year amortization.

The five-year amortization rules are also poorly targeted to encourage pollution control activities. The subsidy is available only with respect to depreciable assets, and thus provides no incentive for numerous other ways of reducing pollution from existing plants, such as using cleaner but more expensive grades of fuel and other raw material inputs. Favoring capital intensive pollution control measures wastes scarce resources to accomplish the program objective.

Finally, although the special amortization rule for pollution control facilities was originally a temporary measure, it was extended indefinitely in 1976. Even if some justification existed for transitional relief to operators of old plants, there is no basis for an ongoing subsidy of pollution control costs.

3. **Qualified child care facilities.** The special rule permitting five-year amortization of expenditures to construct or rehabilitate child care facilities applies only to expenditures made before January 1, 1982, and, therefore, has effectively expired.

4. **Rehabilitation of low-income housing.** Historically, low-income housing has benefited from a variety of direct and indirect government subsidies, including rental subsidies, grants, loans, and credit supports and guarantees. A number of Federal programs, including the housing voucher program initiated in 1983, have provided direct or indirect assistance to low-income families unable to afford market rents. Also initiated in 1983 were two programs providing grants to assist private sector rehabilitation and new construction of low-income housing. Direct low-interest loans are made available to assist low-income individuals in rural areas to obtain adequate housing. Finally, a number of mortgage insurance and guarantee programs make credit available to many families who could not afford to purchase homes in the absence of such measures.

In addition to these targeted direct subsidies, the current income tax laws contain numerous provisions which encourage investment in real estate, including housing. These provisions include (1) accelerated depreciation of real property, (2) full deductibility of interest, including the portion of interest intended to compensate the lender for the effects of inflation, (3) reduced tax rates for capital gains realized on disposition of real property, (4) relaxed recapture rules for dispositions of real property, (5) exemption of real estate investments from the limitation of losses to amounts at risk, and (6) tax-exempt status for bonds issued to finance low-income rental property. In addition, several special provisions apply only to low-income housing, including (1) immediate deductibility of construction-period interest and taxes, (2) the 15-year ACRS recovery period, and (3) five-year amortization of rehabilitation expenditures.

The tax benefits associated with real estate investment attract capital from high-income taxpayers who are willing to trade negative cash flows or below-market returns for substantial tax savings, and therefore appear to cause increased investment in real estate, including low-income housing. However, in a 1977 report entitled "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives," the Congressional Budget Office estimated that, because of the costs of packaging tax shelters and the high after-tax returns enjoyed by tax shelter investors, less than one-half of government revenue losses attributable to real estate tax shelters ever reach builders and developers. Thus, to the extent that the current tax laws encourage investment in low-income housing, the incentive is unnecessarily costly to the government.

Moreover, the provision permitting five-year amortization of expenditures to rehabilitate low-income housing, by itself, is probably insufficient to cause taxpayers to invest in low-income properties. The tax consequences of such investments are beneficial only in conjunction with accelerated depreciation of other capitalized costs (such as the purchase price of the unrehabilitated property), full deductibility of interest, and high marginal tax rates. In a tax system with economic depreciation, indexation of capital gains and interest, and reduced marginal rates, five-year amortization of rehabilitation expenditures would be of dubious value, and would merely complicate the tax laws.

If additional measures are needed to stimulate investment in low-income housing, existing targeted spending programs should be expanded.

5. Railroad rolling stock. The special rule permitting five-year amortization of the adjusted basis of railroad rolling stock applies only to rolling stock placed in service before 1976, and, therefore, has effectively expired.

6. Qualified railroad grading and tunnel bores. For much of its history, the U.S. railroad industry was subject to rate and service regulation designed to favor shipments of bulk raw materials over shipments of finished and semi-finished products. As a consequence, the industry's capacity to haul bulk commodities, demand for which is highly seasonal in volume, depended heavily on cross-subsidization from rates that were charged for "high value" manufactured goods.

In general, such cross-subsidization was possible so long as the railroad industry held a virtual monopoly on long distance overland haulage. Competition from trucking progressively eroded this monopoly, however, shifting the railroad's mix of transported goods to the low-value markets. Railroad rate schedules failed to keep pace with the shift in markets, depressing industry earnings and causing investment in right of way and rolling stock to decline.

In 1969, Congress responded to the railroad industry's financial plight by allowing 50-year amortization for the cost of railroad grading (the basic roadway, but not the track, ties, and ballast) and tunnel bores, which, as assets in the nature of land improvements, had previously been considered nondepreciable. This special amortization rule, after its expansion in 1976, applied regardless of when the assets were placed in service, effectively granting railroad companies a 50-year stream of tax deferrals.

The special amortization rule for railroad grading and tunnel bores is a poorly conceived subsidy. The value of the subsidy depends on a railroad's historical investment in grading and tunnel bores. In many cases, these costs were incurred prior to imposition of the income tax, and, in any event, are not correlated with regulatory mispricing.

In addition, the subsidy targets its benefits to railroads least in need of or entitled to relief. Those railroads most affected by regulatory mispricing may not have significant taxable income, and thus may realize no benefit from the subsidy. Only profitable railroads can take full advantage of the special amortization rules, yet they may have escaped the burdens that the subsidy is intended to offset.

7. **Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures.** In recognition of various economic conditions which disfavor small unit farming, often called family farming, Federal programs to mitigate farm price and income instability have been in place since 1926. In addition to price support programs, farmers have access to Federal credit on a subsidized basis. The Department of Agriculture also administers programs for agricultural conservation and rural water supply, as well as providing farmers broad scale technical and management assistance.

The extensive Federal involvement in agricultural input and output markets makes additional tax-based subsidies unnecessary and inefficient. Outlays to drain marshy soil, create ponds, install irrigation ditches, and condition soil, all have the objective of yielding greater farm output in the future; under ordinary accounting principles they should be capitalized or inventoried -- treated as the purchase of an asset -- rather than treated as a cost of the current year's output. If the land-improving investments are rationally made, the farmer has merely exchanged cash for an asset of equal value -- improved land -- the expected market value of which will accrue to him as output occurs.

Finally, as with many other tax-based subsidies, the special expensing rules for farmers are of full value only to those with significant income. This effectively denies the benefits of the subsidy to the new or unprofitable farmer, who is thus given a relative disincentive for farm improvements.

8. **Reforestation expenditures.** It has been argued that the market price of timber understates the social value of forested land because some important benefits are not expressed in the market price. National security, flood control, arresting land erosion that degrades the quality of streams, and opportunities for outdoor recreation are claimed to be among the additional benefits derived from forested land.

In view of these "externalities," government invervention to increase the volume of forest output may be justified. Thus, $1.8 billion was spent in fiscal year 1984 for management of more than 100 million acres of national forests and for cooperative forestry and forestry research.

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In addition to these direct budget expenditures, present law contains tax subsidies intended to encourage forestry by small-scale landowners. All taxpayers investing in timberland are entitled to an investment tax credit equal to ten percent of up to $10,000 of forestation expenditures each year. In addition, the total amount eligible for the credit may be amortized over seven years, notwithstanding the fact that the taxpayer has expended only 90 percent of that amount and the trees planted are likely to appreciate in value.

Even if one agrees that there are "externalities" in forestry in excess of the direct expenditures presently provided in the Federal budget, the tax subsidy is so poorly designed that its continuation is difficult to justify. Any forestation expenditure qualifies for the investment credit and amortizaton, whether or not it yields recreational, flood control, or erosion control benefits, or relates to a tree species with national security significance. Moreover, the subsidy is so structured that it cannot appreciably affect marginal industry investment. Due to economies of scale, most commercial forestry (i.e., that type which is likely to produce external benefits of the kind that justify a subsidy) occurs on a scale far in excess of $10,000 per year. For most commercial forestry, therefore, the subsidy is the equivalent of a fixed grant, plus assured tax deferral per year, and is independent of the taxpayer's decision to increase marginal qualified expenditures. Consequently, repealing these tax subsidy provisions would reduce the budget deficit without measurably increasing soil erosion and flood damage, or reducing recreational opportunities and national security.

Proposal and Effective Dates

1. **Trademark and trade name expenditures.** The current election to amortize trademark and trade name expenditures would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

2. **Certified pollution control facilities.** The election to amortize the cost of certified pollution control facilities would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

3. **Qualified child care facilities.** This provision would be deleted from the Code as deadwood, since it applies only to costs incurred prior to January 1, 1982.

4. **Rehabilitation of low-income housing.** The election to amortize expenditures to rehabilitate low-income housing would be

repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposed is introduced in legislation.

5. **Railroad rolling stock.** This provision would be deleted from the Code as deadwood, since it applies only to rolling stock placed in service prior to 1976.

6. **Qualified railroad grading and tunnel bores.** The election to amortize the cost of qualified railroad grading and tunnel bores would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

7. **Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures.** The elections to deduct currently expenditures for soil and water conservation, fertilizer and soil conditioning, and land clearing, would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

8. **Seven-year amortization of reforestation expenditures.** The election to amortize reforestation expenditures would be repealed. Repeal would be effective for expenditures paid or incurred on or after January 1, 1986, other than expenditures paid or incurred pursuant to binding contracts entered into prior to the date that the proposal is introduced in legislation.

Analysis

In general, costs that currently qualify for the special expensing and amortization rules discussed in this section create wasting or non-wasting long-lived assets. Thus, repeal of the special rules would cause those costs to be capitalized or inventoried, and recovered under the normal cost recovery rules or at the time of disposition. The effect on taxpayer behavior of such repeal would generally depend on (1) the extent to which marginal investment choices are influenced by the special rules provided by current law and (2) the degree of neutrality achieved by the cost recovery rules replacing the special provisions.

1. **Trademark and trade name expenditures.** An investment in a trademark or trade name creates an intangible asset for which there is no reason to impute deductions for a decline in value over time. Accordingly, if such an investment were capitalized it would be recovered only upon disposition of the asset. Thus, the interest-free tax deferral which currently results from the tax treatment of trademark and trade name expenditures would be eliminated.

Nevertheless, the effect of repeal on business would be minimal. Unlike investments in plants and equipment, investments in trademarks and trade names do not vary with firm output. Rather, they are fixed capital costs which are relatively small compared to the initial investment in an enterprise, and constitute a declining proportion of total investment as firm output increases. Thus, the importance of trademark and trade name income tax deferral is initially small and is thereafter of diminishing significance to firms with average rates of growth.

2. **Certified pollution control facilities.** Pollution control facilities that are currently eligible for five-year amortization are for the most part comprised of equipment which, under a system of economic depreciation, would be depreciated over periods longer than five years. Since, under such a system, the relative tax benefit from investing in such equipment, compared to the tax consequences of investing in other means of controlling pollution, would be reduced or eliminated, choices of pollution control methods would be based on economic, rather than tax, considerations. Since compliance with emission control standards is mandatory in most cases, the functional value of investments in pollution control facilities would not decline. However, under a neutral cost recovery system, only the most cost-efficient pollution control methods would be used.

3. **Rehabilitation of low-income housing.** In the absence of five-year amortization of expenditures to rehabilitate low-income housing, such expenditures would be recovered in accordance with the normal rules for depreciating real property. Accordingly, repeal of this amortization provision would reduce to some extent the currently inflated after-tax return earned by investments in low-income housing rehabilitation. Nevertheless, the proposal is not expected to diminish the volume of low-income housing.

A tax preference for "rehabilitated" low-income housing directs private investment toward rehabilitation rather than new construction. New construction, however, even of housing for moderate- and high-income families, increases the stock of housing for low-income occupancy as tenants relocate. Thus, increased rehabilitation induced by tax subsidies largely displaces new construction. Accordingly, repeal of the subsidy would have little effect on the availability of low-income housing.

4. **Qualified railroad grading and tunnel bores.** In the absence of 50-year amortization of expenditures for railroad grading and tunnel bores, such expenditures should generally be capitalized as costs of land improvements, and recovered upon disposition of the improvements or the underlying land. This treatment would be consistent with the nature of the asset created by such expenditures, the value of which generally does not decline over time. In view of the fact that future improvements of and additions to railroad grading and tunnel bores are likely to be insubstantial in relation to improvements and additions of track and rolling stock, repeal of

50-year amortization should not have an appreciable effect on the volume of railroad investment or on after-tax rates of return on such investment.

5. Soil and water conservation expenditures, fertilizer and soil conditioning expenditures, and land clearing expenditures. In the absence of special expensing rules for farmers' expenditures for clearing, conditioning, and conserving farmland, some of these expenditures would be capitalized as a cost of improving the land to make it suitable for farming and, as such, would be recovered under normal cost recovery rules. To the extent that farmers who make such investments have significant marginal tax rates (generally large-scale operators and corporations), the loss of tax deferral would make investments in land improvement less attractive than alternative investments, such as investments in farm machinery or in other industries. In addition to the resulting social gain from a better allocation of scarce private capital, eliminating this subsidy could result in a reduced level of Federal expenditures for price-support programs, since expansion of farm acreage would no longer be encouraged by the tax laws.

6. Reforestation expenditures. Repeal of seven-year amortization of qualified reforestation expenditures and the associated ten percent investment credit would have no measureable effect on the rate of investment in private forest lands. These incentives are structured so that they do not affect forest investment decisions; they apply only to the first $10,000 of forestation investment, a rate far below the annual size of a viable commercial forestry operation. The existing tax subsidies, however, also benefit farmers and other landowners who use tree planting to control wind-related soil damage or otherwise to improve the value of their land. Absent the current subsidy, this type of tree planting probably would decline and investors would select other investment projects with higher market yields.